Highlights of Chile

2008-2009

Chile's most significant economic, tax and labor events of 2008

PricewaterhouseCoopers

Synopsis

- Economic growth slowed down in the second half of 2008 due to the global economic and financial crisis.
- A Free Trade Agreement signed with Panama and a limited Economic Complementation Agreement signed with Cuba in 1999 came into force during 2008.
- The Central Bank of Chile raised interest rates in February, June, July, August, September and October in an effort to contain inflation, though it has reduced them sharply in early 2009

Political environment

According to the statistics of the Centro de Estudios Públicos, the third year of Mrs. Michelle Bachelet's government began with a 39% approval rating and ended with 43%. The cause of this rise in the polls is mainly associated with the latest economic measures implemented by the government.

The current composition of the Lower Chamber is of 53 representatives from the center right coalition (Alianza por Chile), 57 from the governing center left coalition (Concertación), 3 from a regionalist party (Partido Regionalista de los Independientes), and 7 independents.

The Senate is made up of 16 senators from the center right coalition, 17 from the center left coalition, 1 from a newly incorporated party (Chile Primero), and 4 independents.

Thus, the Government does not have a clear majority in either Chamber.

Economic Performance, Tax and Labor Legislation

1 GDP

During 2008, GDP grew by an estimated 3.5%, affected by the downturn observed in the last quarter of 2008. Also, the change in macroeconomic scenario was very important, characterized mainly by the deterioration in the external and internal credit conditions and the significant fall in exports prices.

Chile's per capita income is approximately US$ 12,997, according to the Human Development Index elaborated by the United Nations Development Programme.

2 Trade Balance and Balance of Payments

The trade balance for 2008 showed a surplus of approximately US$ 10,000 million, 57% lower than the previous year. Even though the average copper price reached approximately US$ 3.15 per pound, which represents the second highest nominal value for the commodity in Chilean history, the abovementioned reduction in the surplus is explained by a significant decrease in exports and an increase in imports.

This is the tenth consecutive year of surplus.

Foreign exchange reserves were US$ 23,162 million at the end of the year, compared to US$ 16,910 million in 2007, US$ 19,428 million in 2006, US$ 16,963 million in 2005, US$ 16,016 million in 2004, and US$ 15,851 million in 2003.

3 Double Taxation Agreements

Chile has double taxation agreements (DTAs) in force with Argentina, Brazil, Canada, Croatia, Denmark, Ecuador, France, Ireland, Malaysia, Mexico, New Zealand, Norway, Paraguay, Spain, Peru, Poland, Portugal, South Korea, Sweden, and the United Kingdom.

DTAs with Belgium, Colombia, Russia, Switzerland and Thailand have been already signed and are currently pending ratification by Congress.

DTAs are being negotiated with Australia, Austria, China, Cuba, Czech Republic, Finland, Hungary, India, Italy, Kuwait, The Netherlands, the United States, Uruguay, and Venezuela.

DTA negotiations with South Africa have concluded and the treaty is awaiting signature by both countries.

4 Trade agreements

At present, there are Free Trade Agreements (FTAs) in force with the United States, China, Canada, Mexico, South Korea, E.F.T.A. (Iceland, Liechtenstein, Norway, and Switzerland), Japan, Central America, Australia and Panama. The latest agreement, with Peru came into force in early 2009.

Also, a limited FTA was signed with India, which benefits 98% of Chilean exports to that country (including minerals, wood pulp, timber, and salmon). On the other hand, after almost 10 years since its signature, on August 28, 2008 Chile enacted a partial Economic Complementation Agreement (ECA) with Cuba which will favor agricultural food products that are exported to that country. ECAs also exist with Argentina, Bolivia, Colombia, Ecuador, Mercosur and Venezuela.

At present, an FTA with Colombia has been signed and is pending ratification by Congress. Also, Chile is negotiating FTAs with Malaysia, Thailand, Turkey, and Vietnam.

Agreements of Economic Association were signed with the members of the EU and of the P4. The P4 is formed by New Zealand, Singapore, Brunei Darussalam, and Chile.

5 Foreign debt

Foreign debt has been steadily increasing, and reached a gross amount of approximately US$ 67,324 million in October 2008. This increase has been caused by an expansion of long-term liabilities held by companies and individuals. Also, short term banking liabilities have increased, mainly due to the substitution of local financing.

Despite the financial global crisis, Chilean banks and companies have been able to obtain new loans or renew existing ones abroad, although at higher spreads and shorter terms than used to be the norm.

A large share of the foreign debt is long-term. Furthermore, 75% of the external debt corresponds to loans to private companies.

Most of the debt has been granted by banks, while a smaller percentage has been covered by companies. Regarding banking creditors, one third is from the United States, 30% from the Euro Zone, 17% from Latin American countries, and 4% from the United Kingdom.

6 Foreign investment

During 2008, total foreign direct investment (FDI) amounted to US$ 19,222 million at November 2008, an increase of 25% in relation to the previous year. Of this total investment, 55% was channeled through DL 600, which represents a record for this kind of investment in the past 10 years, and 45% through Chapter XIV.

Between January and the first two weeks of December 2008, the main sectors receiving DL 600 FDI were Mining (43.8 %), Services, Electricity, Gas & Water, and Transport and Communications (56.2%).

The breakdown by sector information is not yet available for chapter XIV FDI

7 Outbound investment

Outbound investment was approximately US$ 2,882 million in 2008, which represents 37% less than that registered in 2007. This drop is explained by the major uncertainty and volatility of the world economy and because 2007 was a year with more activity, particularly in mergers and acquisitions.

Of this amount, the destinations were Peru (26%), Colombia (18 %), Argentina (17%), Pakistan (9%), Brazil (7%), Mexico (6%) and Ecuador (4%), among others. In total, Latin America received 87% of Chilean investment, followed by Asia (9%), other countries of America (3%), and Europe and Africa (both 1%). On the other hand, the sectors for investment were commerce (39%), industry (19%), real estate and building (9%), mining (9%), tourism (7%), energy (7%), transport sectors (5%), among others.

8 Sector performance

In comparison with 2007, industrial production grew only 0.6% as at December 2008. This growth is much lower than expected due to the downturn observed in the last quarter of 2008, the appreciation of the exchange rate and the high inflation observed in the first half of the year.

The mining sector only increased 0.2% in December 2008, showing a worse than expected performance, caused largely by a sharp drop in the copper price in the last quarter of the year.

9 Country risk

On December 17, 2008, Standard & Poor's kept Chile's credit risk rating in foreign currency at "A+". The credit risk rating in local currency and its transfer and convertibility evaluation was also kept at "AA". This consolidates Chile's leading position in Latin America as the country with the best credit risk rating. This classification reflects Chile's low level of public and external net indebtedness, its fiscal flexibility and the sustained prosperity of its economy.

Furthermore, 2 of the Economic and Social Stabilization Funds created in 2007 accumulate funds equivalent to 17% of 2008 GDP. Notwithstanding the above, a new package of economic measures will be financed by these funds, which at November 30, 2008 amounted to US$ 19,164 million. The objective of these measures is to speed up the economy, by giving incentives particularly to individuals and mid size companies.

10 Labor

At the beginning of 2008, unemployment was at 7.56%. During the rest of the year the indicator stayed at approximately 7.5%. The indicator's low fluctuation is explained by a 3.6% rise in the labor force, while employment grew 3.4% in 12 months.

The 2008 average annual rate was 7.8%, and still represents a low level of unemployment.

11 Inflation

During 2008, annual inflation measured by the Consumer Price Index was 7.1%. This high index is derived mainly from a sustained increase in global food prices, especially corn and wheat, the sustained rise in prices for oil and oil-based products, and the continuing effects of the high 2007 annual inflation rate of 8%. However, due to the global economic crisis, commodities and general prices started to fall, which limited this annual rate from getting even higher.

Inflation was 2.6% in 2006, 3.7% in 2005, 2.4% in 2004, 1.1% in 2003 (the lowest in decades), and 2.8% in 2002.

12 Exchange rates

The "observed" exchange rate, which is the average of buying and selling rates for transactions in the Formal Market, closed at year end at Ch$ 636.45 per US dollar, compared to Ch$ 496.89 at the previous year end.

The exchange rate reached its highest value for the year on October 28 at Ch$ 676.75 and its lowest value on March 19 at Ch$ 431.22.

13 Interest rates

The Central Bank raised interest rates 6 times during 2008. The benchmark lending rate was at 6.17 % at the beginning of the year and reached 8.25 % at the year end. During the first quarter of 2009, the Central Bank has lowered its benchmark rate to 2.25% in response to the improved inflation scenario and the slowing of the economy.

14 Foreign exchange regulations

Since 2002, foreign exchange operations fall into 3 categories: (i) operations that must be performed through the formal exchange market (i.e. a commercial bank) and informed to the Central Bank; (ii) operations that must be performed through the formal exchange market; or (iii) operations that need only be informed to the Central Bank. Thus, there are no transactions that require prior approval by the Central Bank.

15 Tax legislation

Law No. 20,259 was passed on March 25, 2008, to bring forward a decrease in the Stamp Tax rates originally designed to be fully accomplished in 2009. This law repealed the transitory article fixing the progressive decrease in the applicable rates for Stamp Tax purposes and consequently, lower rates intended for 2009 were applicable immediately.

Under the current decreased rates, Stamp Tax is levied at a rate of 0.1% on the amount of the loan, for every month or fraction of a month between the issuance of the documents until maturity, capped at a 1.2% rate. Documents issued as "payable on demand" or with no maturity date are subject to a 0.5% rate.

Notwithstanding the above, in January 2009, the government announced that this tax will be suspended for one year as one of the economic measures to face the global crisis.

Law No. 20,263 was passed on May 2, 2008, to provide a more flexible treatment for carrying accounting records in foreign currency. Under this alternative provided for the taxpayer, the Chilean IRS may grant the authorization for eligible taxpayers to keep full accounting records in a foreign currency, providing a tax shelter against foreign exchange exposures.

Minor changes were also introduced during 2008 to grant tax benefits for small and medium entrepreneurs, including an increase in the existing credit for investments in fixed assets (up to 8% instead of 4%), and incentives granted to invest in private research and development by creating a credit equivalent to 35% of the amount of the investment.

16 Labor legislation

During 2008 several legal amendments were introduced that generated discussions between the government and the business community. The first one equalizes the legal minimum wage with the so called "basic compensation" or fixed salary. As a result, any individual who is hired for a full-time employment cannot be compensated with a fixed salary amount lower than Ch$ 159,000 (US$ 250) per month.

The second amendment relates to the incorporation of the "seventh day payment" to employees under a variable compensation scheme. This benefit was available in the past for employees under a daily compensation regime only. The benefit is now applied to all employees subject to a compensation that includes both a fixed and a variable component.

17 Prospects for 2009

The Central Bank of Chile forecasts a GDP growth of 2.0% to 3.0% with the risk balance biased downward. Domestic demand forecasts are not optimistic (0.7% annual average) for the first half of the year, although it is expected that demand will recover as a result of the decrease in interest rates.

The Central Bank's long term projections for inflation consider that it will remain anchored at around 3% per annum. Notwithstanding the foregoing, annual inflation will remain high during the first quarter of 2009, and later should decrease to a 3% annual average in the second half of the year.

Local think tanks expect that unemployment will increase during 2009, due to a slowdown in growth.

Forecasts for 2009 are that the exchange rate will fall in comparison with other currencies and reach a similar parity to that observed before September 2008.

The Central Bank's forecast for the average copper price during 2009 is US$ 1.5/lb as compared to US$ 3.15/lb for 2008 and US$ 3.23/lb for 2007.

According to the government's latest unofficial forecast for 2009, GDP growth will be 2% or 3%. This lower trend is a natural consequence of the economic global crisis that is affecting most of the world.

The slowing of the world economy will have a strong impact on Chilean exports, which will also affect local commerce and investments.

The government states that, in comparison to the other countries, Chile is in a better position because of its recent history of fiscal surpluses, a very controlled public debt, a flexible exchange rate policy, and the liquidity and strict fiscal regulation of the financial system.

18 PricewaterhouseCoopers in Chile

PricewaterhouseCoopers (pwc.cl) has been present in Chile since 1914. During these 95 years we have served the most prestigious local and foreign entities operating in Chile. We are the leading firm in the auditing business, with a staff of approximately 850 persons distributed in the cities of Antofagasta, Santiago, Viña del Mar, Concepción, and Puerto Montt.

Our services include auditing, management consulting, executive recruitment, fixed asset valuation, due diligences, technology and software selection, performance improvement, enterprise risk management, tax and legal services, foreign investment registration and structuring, bookkeeping, confidential payroll and corporate finance services. In general, we provide information and advice on how to operate in Chile.

Our main objective is to help our clients be successful and we welcome any questions you may have related to either our services in general or to the information above.

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Front cover image: Torres del Paine National Park, with the Laguna Amarga (Bitter Lagoon) in the foreground. Located in Chile's Region XII - Magallanes -

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